

Internal Audit Policy Manual

The Egypt Capital Markets Development Project



CHEMONICS INTERNATIONAL INC.



March 2001
USAID Contract No. 263-C-00-98-00067-00

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1. INTRODUCTION

1.1 Objective

The objective of the Internal Audit Policy manual is to provide a comprehensive practical guide and learning tool for MCSD internal auditors to discharge their responsibilities as outlined in the Internal Audit Department (IAD) charter. The policies developed in this manual reflect the function of the internal auditing as defined by the Institute of Internal Auditors (IIA) in the United States of America (www.theiia.org).

Internal auditing, as recently redefined by the IIA, is “an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”

1.2 Structure of the Manual

The manual is structured into four sections as follows:

1. Introduction

This chapter outlines the objective of the policy manual and its structure, updating, and control procedures.

2. Internal Audit Department (IAD)

This chapter outlines the environment of the internal auditing function including: the board of directors’ Audit Committee, IAD’s charter, professional standards and code of ethics, and IAD organizational structure and job descriptions.

3. IAD Administrative Policies

This chapter outlines the IAD policies for annual planning, risk assessment, working papers development and review, reporting, organization of audit files.

4. IAD Methodology

This chapter outlines the four-phase methodology followed by MCSD internal auditors for planning, examination and evaluation of information, communicating audit results, and follow-up management responses to the internal audit reports.

1.3 Updating the Manual

The manual should be periodically reviewed and updated by the IAD and/or its advisors to reflect changes in auditing objectives, policies, methodology and standards as well as changes in the IAD charter. The IAD director and the Audit Committee of the board of directors should approve any updates.

1.4 Controller of the Manual

The director of the IAD will be the controller of the manual. The controller will develop procedures for maintenance, using, updating and distributing this manual. The manual is the property of MCSD and must be returned to the company by its holder before leaving the employment or whenever otherwise requested.

Contents of the manual are confidential and must not be disclosed to any unauthorized persons inside or outside MCSD. Persons authorized to access the manual are the IAD managers and staff, and MCSD board of directors or any members of the board of directors and its Audit Committee members. External authorized persons include external auditors, inspectors of the Capital Market Authority (CMA), and those persons given access by a court order.

2. INTERNAL AUDIT DEPARTMENT (IAD)

2.1 The Board of Directors' Audit Committee

2.1.1 Objective

The primary role of the Audit Committee is to provide assurance to the board of directors that MCSD maintains adequate and effective control environment, policies, systems and procedures to ensure:

- Reliability and confidentiality of information pertaining to MCSD and its participants
- Safeguarding of MCSD assets, securities and funds of its customers, and participants and those MCSD is responsible for
- Economic, effective and efficient utilization of resources allocated to MCSD
- Compliance with applicable laws, regulations contracts
- Achievement of MCSD objectives in accordance with approved plans, policies and budgets.

The active participation of the Audit Committee of the board of directors will promote the independence of internal as well as external auditors, especially when the Audit Committee selects the external audit firm and the director of the IAD.

Therefore, this active participation shall insulate the auditors from influences that may affect their independence and objectivity. Moreover, the Audit Committee will serve as a mediator of disputes between the auditors and management.

2.1.2 Formation

The board of directors will form an Audit Committee ranging from 3 to 5 non-executive members of the board of directors. Members of the Audit Committee should be able to read and understand financial statements, including MCSD balance sheet, statements of income and cash flows or, otherwise, will become able to do so within a reasonable period of time after becoming a member of the Audit Committee.

In addition, at least one member of the Audit Committee will have past employment experience in finance or accounting.

Members of the Audit Committee will be independent. To maintain independence, members elected to serve on the Audit Committee will not be:

- An employee of MCSD or any of its affiliates for the current year or for any of the past three years
- A partner, controlling shareholder or executive officer of a business organization that has a business relationship with MCSD

- An individual with a direct business relationship with MCSD
- A buyer or a seller of securities, a spouse or a parent of a minor who buys or sells securities unless given MCSD board of directors prior approval as required by article (10) of law 93 for year 2000

2.1.3 Responsibilities

The Audit Committee responsibilities will encompass the following:

- a) Select external auditors and review the audit fee and the engagement letter
- b) Review draft annual and interim financial statements
- c) Review results of external audits (e.g. qualified audit opinions, audit findings and recommendations)
- d) Review the internal audit annual plans, work schedules, budgets, reports, etc.
- e) Meet regularly with the IAD's director
- f) Review evaluations of internal control
- g) Review the MCSD accounting, financial, and operating controls
- h) Review policies on unethical and illegal procedures and fraud investigations
- i) Review statutory reporting to regulatory agencies
- j) Review complaints to the B.O.D
- k) Participate in the selection of accounting policies
- l) Review the impact of new or proposed legislation or governmental regulations
- m) Review the MCSD's insurance program
- n) Review the external auditor's management letter

2.2 Internal Audit Department Charter

This is the formal document acknowledged and approved by the board of directors'. It defines the purpose, authority and responsibility of MCSD's internal audit department.

2.2.1 Purpose

The IAD has been established by MCSD to provide an independent appraisal for its activities through examining and evaluating those activities. The internal audit department is expected to assist MCSD board of directors, management, and departments and staff in the effective completion of their responsibilities.

Assistance provided by the IAD encompasses furnishing management with analyses, appraisals, recommendations, counsel and information regarding the activities reviewed.

The audit objective includes enhancing and promoting effective controls over MCSD activities at a reasonable cost.

2.2.2 Authority

The IAD reports to the board of directors' Audit Committee and to the managing directors. Direct reporting to the Audit Committee by IAD maintains a competent level of independence for MCSD internal auditors.

The internal audit director and staff are authorized to access all MCSD records, personal and physical properties relevant to the performance of audits and upon coordination with the managing director and other involved MCSD management levels.

To maintain objectivity of MCSD internal auditors, they will not participate in operations. Moreover, they will have neither direct responsibility for, nor authority over, any of the activities subject to their review.

Designing, installing, operating or drafting procedures for MCSD systems is not an audit function, therefore, should not be carried out by MCSD internal auditors. Carrying out such tasks by internal auditors could be construed as a compromise to their objectivity.

Design and operation of controls over MCSD's different activities is the responsibility of management. MCSD would evaluate and advise, but not be engaged in, the design and operation of internal controls over MCSD activities.

2.2.3 Responsibility

Internal audit is an independent appraisal function to examine and evaluate MCSD activities as a service to management and the board of directors. In carrying out their duties and responsibilities, internal auditors will always maintain objectivity and independence.

Responsibilities of the IAD include the following:

- a) Review organizational units within MCSD at appropriate intervals to determine whether they are efficiently and effectively carrying out their functions according to management instructions, policies, and procedures, and in a manner that is consistent with both MCSD objectives and high standards of performance
- b) Determine the adequacy and effectiveness of the MCSD systems of internal accounting and managerial controls
- c) Review the reliability and integrity of financial information and the means used to identify, measure, classify, and report such information

- d) Review the established systems to ensure compliance with those policies, plans, procedures, laws, and regulations that could have a significant impact on operations and reports, and determine whether MCSD is in compliance. Suggest policy where required
- e) Review the means of safeguarding assets and, as appropriate, verify the existence of such assets
- f) Appraise the economy and efficiency with which resources are employed, identify opportunities to improve operating performance, and recommend solutions to problems where appropriate
- g) Review operations and programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned
- h) Coordinate audit efforts with those of MCSD's external auditors
- i) Participate in the planning, design, development, observation, implementation, and testing of major computer based systems to determine whether:
 - 1. There are adequate controls are incorporated in the system
 - 2. A thorough system testing is performed at appropriate stages
 - 3. The system documentation is complete and accurate
 - 4. The needs of systems' users are met
- j) As an SRO, MCSD internal auditors will review controls operated by its participants and their compliance with applicable laws and regulations and MCSD rules.
- k) Review compliance with the MCSD code of ethics and assess whether the highest standards of personal and corporate performance are met
- l) Submit annual audit reports to the Audit Committee of the board of directors on whether:
 - 1. Appropriate action has been taken on significant audit findings.
 - 2. Audit activities have been directed toward the highest risk exposures and toward increasing efficiency, economy, and effectiveness of operations.
 - 3. Internal and external audits are coordinated to avoid duplications.
 - 4. Internal auditing plans are adequate.
 - 5. There is any unwarranted restriction on the staffing and authority of the Internal Audit Department or on access by internal audits to all MCSD activities, records, property, and personnel.

- m) To report to those members of management who should be informed or who should take corrective action, the results of audit examinations, the audit opinions formed, and the recommendations made.
- n) To evaluate any plans or actions taken to correct reported conditions for satisfactory disposition of audit findings. If the corrective action is considered unsatisfactory, hold further discussions to achieve acceptable disposition.
- o) To provide adequate follow-up to ensure adequate and effective corrective actions are taken.

2.3 Standards for the Professional Practice of Internal Auditing

As professionals, MCSD internal auditors will maintain and adhere to the Standards for the Professional Practice of Internal Auditing (SPPIA) issued by the Institute of Internal Auditors (IIA). The purpose of issuing these standards by the IIA is to:

- a) Delineate basic principles that represent the practice of the internal auditing, as it should be.
- b) Provide a framework for performing and promoting a broad range of value-added internal auditing activities.
- c) Establish the basis for the measurement of internal auditing performance.
- d) Foster improved organizational processes and operations.

Compliance with the Standards for the Professional Practice of Internal Auditing is *essential* if the responsibilities of internal auditors (as stated in IAD charter) are to be met.

The standards, which are regularly updated, could be downloaded from the IIA World Wide Web site: www.theiia.org. There is no charge for downloading information.

2.4 IAD's Code of Ethics

The purpose of *IAD's Code of Ethics* is to promote an ethical culture in internal auditing of MCSD. A code of ethics is necessary and appropriate for the IAD's creditability as an independent, objective assurance and consulting activity designed to add value and improve MCSD's operations and to help accomplish its objectives. The IAD's code of ethics should be observed and adhered to by its management, staff and independent consultants and specialists, when employed.

The IAD's code of ethics outlines the principles that are relevant to the profession and practice of internal auditing, and rules of the ethical conduct that describe behavior norms expected from MCSD internal auditors.

The principles are *integrity, objectivity, confidentiality, and competency*. The following are the principles and rules that guide application of those principles:

Integrity

Principle

- The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgement.

Rules: Internal auditors shall

- Perform their work honestly, diligently, and responsibly
- Observe the law and make disclosure expected by the law and the profession
- Not knowingly be a party to any illegal activity, or engage in acts that are discreditable to MCSD or the profession of internal auditing
- Respect and contribute to the legitimate and ethical objectives of MCSD

Objectivity

Principle

- Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

Rules: Internal auditors shall

- Not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. The participation includes those activities or relationships that may be in conflict with the interest of MCSD
- Not accept anything that may impair their professional judgment
- Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review

Confidentiality

Principle

- Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal, professional or, contractual or judicial obligation to do so

Rules: internal auditors shall

- Be prudent in the use and protection of information acquired in the course of their duties

- Not use information for any personal gain or in any manner that would be contrary to the law or service contracts of MCSD or detrimental to the legitimate and ethical objectives of MCSD

Competency

Principle

- Internal auditors apply the knowledge, skills, and experience needed in the performances of internal auditing services.

Rules: Internal auditors shall

- Engage only in those services for which they have the necessary knowledge, skills, and experience
- Perform internal auditing services in accordance with the Standards for Professional Practice of Internal Auditing issued by the Institute of Internal Auditors (IIA)
- Continually improve their proficiency, effectiveness, and quality of their services

2.5 Managing the Internal Audit Department

Managing the IAD will be the responsibility of the internal auditing director. The internal auditing director will ensure that:

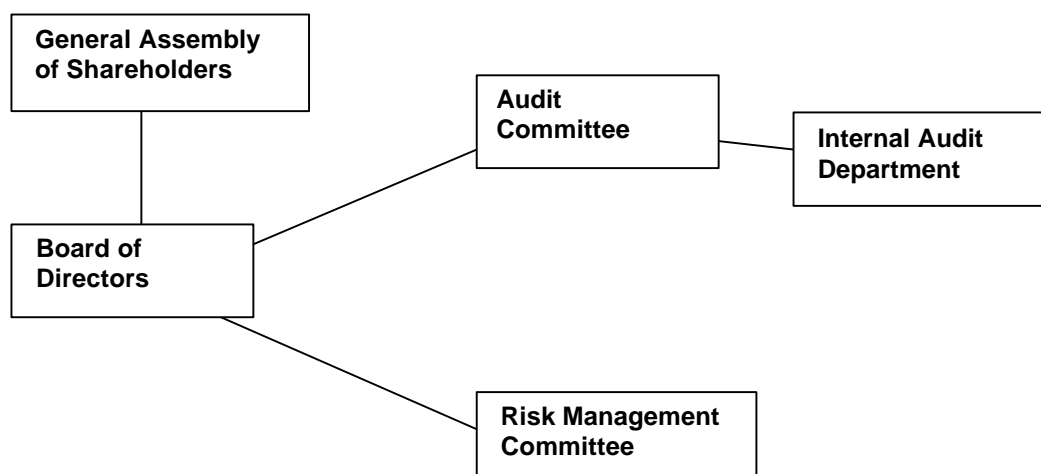
- Audit work fulfills the general purposes and responsibilities approved by the board of directors' Audit Committee
- Audit work conforms to the Standards for the Professional Practice of Internal Auditing
- Departmental resources are employed efficiently and effectively

2.5.1 Organizational Structure

MCSD internal audit department will be always keep an organizational status sufficient to permit the accomplishment of its audit responsibilities in an independent and objective manner.

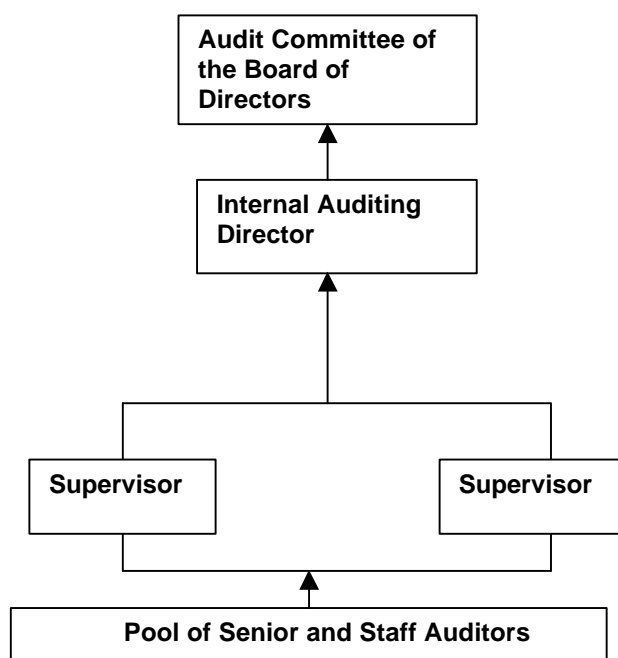
IAD within MCSD

MCSD's Internal Audit Department is an independent department directly reporting to the board of directors' Audit Committee as shown on the following organizational chart:



IAD Internally

The internal structure of the IAD should match its scope of work and its expected role in achieving MCSD's mission, vision, and objectives. In addition, the director of internal auditing should always be updated with best practices and the profession's leaders' approaches in this aspect. Internal auditors should have diversified knowledge and experience to face the challenging and changing demands of internal auditors' services. Considering these factors, a conforming internal structure for the IAD could be as follows:



2.5.2 IAD Policies and Procedures

The director of internal auditing will be responsible for developing written policies and procedures to guide the audit staff in carrying out their duties. This manual will serve as a basic guide in this regard. Moreover, it is the responsibility of the director of internal auditing to develop the administrative policies and procedures for the department. These policies and procedures may include:

- Personnel policies unique to the internal audit department
- Personnel records to be maintained and regularly updated
- Travel instructions
- Expense reports
- Time reports
- Staff evaluations
- Filing system descriptions for permanent files, temporary files, and working paper retention
- Report preparation and review procedures
- Training and education programs

In addition, the IAD will be guided by MCSD personnel manuals, which describes the overall organization and its relation to employees, including:

- MCSD objectives and goals
- MCSD history
- Fringe benefits (medical, pension, life insurance, etc)
- Vacation and sick-pay policies
- Promotion policies
- Development and training programs

2.5.3 IAD Personnel

The director of IAD should establish a program for selecting and developing the human resources of the Internal Audit Department. The program should provide for:

- Developing written job descriptions for each level of the audit staff.
- Selecting qualified and competent individuals.
- Training and providing continuing educational opportunities for each internal auditor.
- Appraising each internal auditor's performance at least annually.

- Providing counsel to internal auditors on their performance and professional development.

2.5.3.1 Internal Auditing Job Descriptions

The well-defined internal auditing job descriptions

- Facilitate recruiting by stating explicit job requirements
- Provide objective promotion criteria
- Are used to justify adequate salaries
- Express MCSD expectations of employees
- Compel the internal auditing function to engage in personnel planning

Annex (1) to this manual outlines job descriptions for MCSD internal auditing staff.

2.5.3.2 Selection of Staff

General guidelines in this area are as follows

- a) For internal auditing within MCSD to be competent, adding value and up to the standards, the director of internal auditing should consider the following:
 1. Staffing provides the personnel necessary to carry out activities of the department
 2. Average personnel are incapable of carrying out progressive programs
 3. Each auditor must have the capacity to expand his abilities as MCSD management emphasizes demands for modern and competent internal auditing services.
- b) The director should set high standards for the internal auditing staff.
- c) Professional education and ability, as well as certain personality characteristics are essential.
- d) Source of internal auditing staff are as follows
 1. Generating recruits internally, advantages include
 - The character, personality, work attitudes, and other personal qualifications of staff members are known
 - Internal recruits are familiar with MCSD policies and practices
 - Internal recruits will have a broader perspective of total MCSD operations
 - Experience and work qualifications can be closely evaluated
 - Internal recruiting can promote good staff morale

2. Recruiting experienced personnel externally, advantages include
 - MCSD can attract specific skills needed
 - The range of possible audit services is broadened
 - New ideas are brought to MCSD
3. Recruiting of university graduates, advantages include
 - Updating accounting and auditing skills
- e) Guidelines for interviewing and testing techniques
 1. The selection of a superior staff is dependent on the ability to evaluate applicants.
 2. The interviews should be carefully planned and structured.
 3. Competent interviewers should be assigned to the task.
 4. Supervisors who will be responsible for the work of the new staff should be present at the interviews.
 5. Appropriate questions and forms should be prepared in advance to evaluate
 - Technical qualifications and educational background
 - Personal appearance
 - Ability to communicate
 - Maturity
 - Persuasiveness
 - Self-confidence
 - Intelligence
 - Motivation
 - Potential to contribute to MCSD
- f) Applicants who have earned the CIA designation have already demonstrated qualifications in internal auditing. Other qualities can be examined by a variety of tests developed by MCSD to provide additional insights into abilities of applicants. These tests will vary with the level of the job to be filled. These tests could include
 1. *Test of writing ability.* An example is to require a written audit report from the applicant based on a prescribed format and a hypothetical situation. Grading criteria for evaluation of writing ability include clarity, coherence, structure, and vocabulary.
 2. *Test of ability to organize thoughts.* An example of such test is to require the applicant to arrange a series of 25 statements to describe an audit finding. The statements are mixed and given identifying numbers. The applicant is asked to arrange them in proper sequence.

3. *Test of ability to distinguish between fact and conjecture.* Applicant must identify the statements of undeniable fact and of mere conjecture in a brief paragraph.

2.5.3.3 Training of Staff

a) Staff orientation

The director of internal auditing should consider that

1. An adequate orientation program provides reasonable assurance that the new employee will become productive promptly. This program will
 - Promotes good employee morale
 - Deters good employees from leaving
2. The orientation program should be well designed and controlled.
3. Appropriate materials should be devised.
4. Employees should be familiarized with MCSD's policies.
5. Internal auditing familiarization may include
 - Introduction to audit staff personnel and other employees
 - Discussion of audit objectives
 - Copies of internal auditing policy and procedures manuals
 - Discussion of duties and responsibilities
 - Control of work
 - General information on MCSD organization
 - Literature on modern internal auditing
 - Working paper techniques
 - Development of deficiency findings
 - Reporting
 - Following-up and getting feedback from the new auditor if he has performed actual field work

b) Objectives of staff training are to:

1. Assist internal auditors to do a better job
2. Add versatility to the Internal Audit Department
3. Help develop supervisory skills
4. Prepare the auditor for promotion
5. Improve the auditor's job satisfaction, resulting in increased loyalty and productivity

c) Possible training formats include:

1. Formal classroom training
2. Self-study
3. Attendance at the IIA and other formal meetings

4. Industry conferences
 5. University courses
 6. On-the-job training
 7. Research projects
- d) One aspect of a successful, ongoing training program is the convening of regular staff meetings to explain new techniques, to discuss new administrative policies, and to receive suggestions from staff members.

2.5.3.4 Evaluation of Internal Auditors

General guidelines are as follows:

- a) Appraisal of each internal auditor's performance is required at least annually.
- b) The evaluation provides a basis for counseling subordinates on their strong and weak attributes, opportunities for advancement, and programs for self-improvement.
- c) The evaluation is a basis for promotions, transfers, and compensation adjustments.
- d) The evaluation is done by the person with responsibility for the particular auditor.
- e) Criteria for evaluation are weighted and applied to performance on specific audits. The criteria include type of skill required, extent of responsibility, scope of effort, and nature of working conditions.
- f) A full explanation of the appraisal process and results should be given to each auditor.

2.5.4 Quality Assurance

The director of internal auditing should establish and maintain a quality assurance program to evaluate the operations of the Internal Audit Department. The purpose of this program is to provide reasonable assurance that internal auditing work conforms to the *Standards for the Professional Practice of Internal Auditing*, the Internal Audit Department's charter, and other applicable standards. Conformity with applicable standards is more than simply complying with established policies and procedures. It includes performance of the Internal Audit Department at a high level of efficiency and effectiveness. Quality assurance is essential to achieving such performance, as well as to maintaining the Internal Audit Department's credibility with those it serves.

A quality assurance program should include the following elements:

- a) Supervision
- b) Internal reviews
- c) External reviews

2.5.4.1 Supervision

Supervision of the work of internal auditors should be carried out to assure conformity with internal auditing standards, departmental policies, and audit programs. Adequate supervision is the most fundamental element of a quality assurance program. As such, it provides a foundation upon which internal and external reviews can subsequently be built. Supervision is a process that begins with planning and continues throughout the examination, evaluation, report, and follow-up phases of the audit assignment.

The director of internal auditing is responsible for ensuring that appropriate audit supervision is provided. Guidelines for effective supervision are, as provided through the IIA standards, as follows

- a) Supervision includes:
 - Ensuring that the auditors assigned possess the requisite knowledge and skills.
 - Providing appropriate instructions during the planning of the audit and approving the audit program.
 - Seeing that the approved audit program is carried out unless changes are both justified and authorized.
 - Determining that audit working papers adequately support the audit findings, conclusions, and reports.
 - Ensuring that audit reports are accurate, objective, clear, concise, constructive, and timely.
 - Ensuring that audit objectives are met.
 - Providing opportunities for developing internal auditors' knowledge and skills.
- b) Appropriate evidence of supervision should be documented and retained.
- c) The extent of supervision required will depend on the proficiency and experience of internal auditors and the complexity of the audit assignment. Appropriately, experienced internal auditors may be utilized to review the work of other internal auditors.
- d) All internal auditing assignments, whether performed by or for the Internal Audit Department, remain the responsibility of its director. The director is responsible for all-significant professional judgments made in the planning, examination, evaluation, report, and follow-up phases of the audit assignment. The director should adopt suitable means to ensure that this responsibility is met. Suitable means include policies and procedures designed to:

1. Minimize the risk that professional judgments may be made by internal auditors, or others performing work for the Internal Audit Department, that are inconsistent with the professional judgment of the director such that a significant adverse effect on the audit assignment could result.
 2. Resolve differences in professional judgment between the director and internal auditing staff members over significant issues relating to the audit assignment. Such means may include (a) discussion of pertinent facts; (b) further inquiry and/or research; and (c) documentation and disposition of the differing viewpoints in the audit working papers.
- e) Supervision extends to staff training and development, employee performance evaluation, time and expense control, and similar administrative areas.

2.5.4.2 Internal Reviews

Internal reviews should be performed periodically to appraise the quality of the audit work performed. These reviews should be performed in the same manner as any other internal audit.

- a) Formal internal reviews are periodic self-assessments of the Internal Audit Department. These reviews generally are performed by the director of internal auditing. Reviews by the director of internal auditing of a sample of audits (and areas of audit administration) provide training, exchange of ideas, and greater uniformity, as well as assurance to the director of internal auditing.
- b) Feedback from auditees (in addition to that from personal contact) through the use of questionnaires or surveys, either routinely after each audit or periodically for selected audits. This process will elicit management's perception of the Internal Audit Department and may result in suggestions to make it more effective and responsive to management needs.

2.5.4.3 External reviews

External reviews of the IAD should be performed to appraise the quality of the department's operations. These reviews should be performed by qualified persons who are independent of MCSD and who do not have either a real or apparent conflict of interest. Such reviews should be conducted at least once every three years. On completion of the review a formal, written report should be issued. The report should express an opinion as to the department's compliance with the *Standards for the Professional Practice of Internal Auditing* and, as appropriate, should include recommendations for improvement.

- a) External reviews can have considerable value to the director and other members of the Internal Audit Department. Another important purpose of external reviews is to provide independent assurance of quality to senior management, the board of directors' Audit Committee who relies on the work of the Internal Audit Department.
- b) The director of internal auditing should discuss with senior management and the Audit Committee the nature of an external review in the context of the

overall quality assurance program and should involve them in the selection of an external reviewer.

- c) External reviews should be performed by qualified individuals who are independent of MCSD and who do not have either a real or an apparent conflict of interest. Qualified individuals are persons with the technical proficiency and educational background appropriate for the audit activities to be reviewed and could include internal auditors, from outside MCSD, or the external auditors.
- d) Upon completion of an external review, the review team should issue a formal report containing an opinion as to the department's compliance with the *Standards*. The report should also address compliance with the department's charter and other applicable standards and include appropriate recommendations for improvement. The report should be addressed to the Board of directors' Audit Committee. The director of internal auditing should prepare a written action plan in response to the significant comments and recommendations contained in the report of external review. Appropriate follow-up is also the director's responsibility.
- e) External reviews should be conducted at least once every three years. However, there may be circumstances that justify a different interval. These circumstances include: (a) significant review and monitoring by the board and controlling bodies and (b) the relative stability of the Internal Audit Department's charter, organization, staff, and catalog of auditable activities. The nature, scope, degree of independence, and overall results of the internal review program should also be considered in determining the external review interval.
- f) External review is an important element of the program for achieving quality assurance. However, if resources are limited, or for other reasons previously noted, the Internal Audit Department may be currently unable to obtain an external review. In these circumstances, more emphasis should be placed on supervision, periodic internal reviews, and other quality assurance methods that are available to the department. It is the responsibility of the director of IAD to annually assess the conditions, which restrict an external review.

2.6 IAD Coordination with External Auditor

2.6.1 Needs for coordination

- a) The external auditors' ordinary examination is designed to obtain sufficient evidential matter to support an opinion on the overall fairness of the annual financial statements. The scope of the work of external auditors is determined by their professional standards, and they are responsible for judging the adequacy of procedures performed and evidence obtained for purposes of expressing their opinion on the annual financial statements. Internal and external auditing work should be coordinated to ensure adequate audit coverage and to minimize duplicate efforts. Actual coordination with the external auditors is the responsibility of the director of internal auditing.

- b) In coordinating the work of internal auditors with the work of external auditors, the director of internal auditing should ensure that work to be performed by internal auditors does not duplicate the work of external auditors, which can be relied on for purposes of internal auditing coverage. Internal auditors should conduct examinations in a manner that allows for maximum audit coordination and efficiency.
- c) The director of internal auditing may agree to perform work for external auditors in connection with their annual audit of the financial statements. Work performed by internal auditors to assist external auditors in fulfilling their responsibility is subject to all relevant provisions of the Standards for the Professional Practice of Internal Auditing.
- d) External auditors may be required by their professional standards to ensure that certain matters are communicated to the board. The director of internal auditing should communicate with external auditors regarding these matters to have an understanding of the issues. These matters may include:
 - Significant control weaknesses
 - Errors and irregularities
 - Illegal acts
 - Management judgments and accounting estimates
 - Significant audit adjustments
 - Disagreements with management
 - Difficulties encountered in performing the audit

2.6.2 Coordination of audit efforts

Coordination of audit efforts involves:

- a) Periodic meetings to discuss matters of mutual interest.

Planned audit activities of internal and external auditors should be discussed to assure that audit coverage is coordinated and duplicate efforts are minimized. Sufficient meetings should be scheduled during the audit process to assure coordination of audit work and efficient and timely completion of audit activities, and to determine whether findings from work performed to date require that the scope of planned work be adjusted.

- b) Access to audit programs and working papers of each other.

Access to the external auditors' programs and working papers may be important in order for internal auditors to be satisfied as to the propriety for internal audit purposes of relying on the external auditors' work. Such access carries with it the responsibility for internal auditors to respect the confidentiality of those programs and working papers. Similarly, access to the internal auditors' programs and working papers should be given to external auditors in order for external auditors to be satisfied as to the propriety, for external audit purposes, of relying on the internal auditors' work.

- c) Exchange of audit reports and management letters.

1. Internal audit reports, management's responses to those reports, and subsequent Internal Audit Department follow-up reviews should be made available to external auditors. These reports assist external auditors in determining and adjusting the scope of work.
 2. Internal auditors need access to the external auditors' management letters. Matters discussed in management letters assist internal auditors in planning the areas to emphasize in future internal audit work. After review of management letters and initiation of any needed corrective action by appropriate members of management and the board, the director of internal auditing should ensure that appropriate follow-up and corrective action have been taken.
- d) Common understanding of audit techniques, methods, and terminology. It may be more efficient for internal and external auditors to use similar techniques, methods, and terminology to effectively coordinate their work and to rely on the work of one another.

3 IAD ADMINISTRATIVE STANDARDS

3.1 Annual Internal Audit Plan

Annually, the director of IAD will develop an audit plan. This planning process should be consistent with the internal audit department's charter and the goals of MCSD. The planning process involves establishing 1) goals 2)-audit work schedules 3) staffing plans and financial budgets 4) activity reports.

The goals of the IAD should be measurable and capable of accomplishing specific operating plans and budgets. Examples of some goals the IAD might establish are listed below:

- Performance standards – Actual man-hours versus budgeted man-hours
- Measurable cost reductions due to increased efficiencies within the IAD
- Timely completion of the internal audit work schedule
- Increased education of IAD staff
- Stability of staff turnover
- Development and implementation of new audit techniques to increase efficiency and effectiveness of the internal audit examinations
- Implementation of computer assisted audit software (CAAS)

The internal audit work schedule should be divided into two section 1) ongoing internal work, and 2) annual internal audit. Ongoing internal audit work is work performed on a scheduled periodic basis, weekly, monthly, or quarterly. Annual internal audit work is the schedule of audits or reviews the IAD would like to complete during the year. Annual internal audit work schedules should include:

- a) What activities are to be audited
- b) When they will be audited
- c) The estimated time required, taking into account the scope of the audit work planned and the nature and extent of the audit work performed by others

When establishing the annual audit work schedule the IAD should assess its priorities by reviewing the following:

- a) The date and results of the last audit
- b) Financial exposure
- c) Potential loss and risk
- d) Requests by management
- e) Major changes in operations, programs, systems, and controls
- f) Opportunities to achieve operating benefits

- g) Changes to and capabilities of the internal audit staff

The annual internal audit work schedules should be sufficiently flexible to cover any unanticipated demands on the IAD.

3.2 Risk Assessment Methodology

Risk assessment is a process that is crucial to the development of an effective internal audit work schedule. The risk assessment process should include, but are not limited to:

- a) Identification of auditable activities
- b) Identification of relevant risk factors
- c) Assessment of their relative significance

The term *risk* is “the probability that an event or action may adversely affect the organization.”

The effects of risk can involve:

- An erroneous decision from using incorrect, untimely, incomplete, or otherwise unreliable information.
- Erroneous record keeping, inappropriate accounting, fraudulent financial reporting, financial loss and exposure.
- Failure to adequately safeguard assets.
- Customer dissatisfaction, negative publicity, and damage to the organizations reputation.
- Failure to adhere to organizational policies, plans and procedures. Or not complying with relevant laws and regulations
- Acquiring resources uneconomically or using them inefficiently or ineffectively.
- Failure to accomplish established objectives and goals for operations, functions or programs

The first phase of the risk assessment process is to identify and catalog the *auditable activities*. Auditable activities consist of those subjects, units, or systems that are capable of being defined and evaluated. Auditable activities may include, but are not limited to:

- Policies, procedures and practices
- Cost centers, profit centers, and investment centers
- General ledger account balances

- Information systems (manual and computerized)
- Major contracts and programs
- Organizational units such as service lines (*e.g. Information Department, Legal Affairs, Settlement Guaranty Fund, etc...*)
- Individual activities such as information technology, operations, finance, accounting purchasing, marketing, training, and human resources
- Transaction systems for activities such as receiving, verification, maintenance, settlement, disbursement, custody, cost accounting, treasury, payroll, and capital assets
- Financial statements
- Laws and regulations

Risk factors are the criteria used to identify the relevant significance of, and likelihood that, conditions and/or events may occur that could adversely affect the organization. The number of risk factors utilized should provide the Director of Internal Auditing with confidence that the risk assessment is comprehensive. Risk factors may include, but are not limited to:

- Ethical climate and pressure on management to meet objectives
- Competence, adequacy and integrity of personnel
- Asset size, liquidity, or transaction volume
- Financial and economic conditions
- Competitive conditions
- Complexity or volatility of activities
- Impact of customers, suppliers, and government regulations
- Degree of computerized information systems
- Geographical dispersion of operations
- Adequacy and effectiveness of the system of internal control
- Organizational, operational, technological, or economic changes
- Management judgements and accounting estimates
- Acceptance of audit findings and corrective action taken
- Date and results of previous audits or examinations

The director of IAD may decide to weigh the risk factors to signify their relative significance. The weighing of risk factors reflects the director's judgement about the relative impact a factor may have on selecting an activity to audit.

Risk Assessment is the systematic process for assessing and integrating professional judgements about probable adverse conditions and/or events. A global *risk assessment* process for the organization should provide a means of organizing and integrating professional judgement for development of the internal audit work schedule. The director of Internal Auditing should assign higher audit priorities to activities with higher risks.

The director of IAD should incorporate information from a variety of sources into the risk assessment process. Sources of information should include, but are not limited to:

- Discussions with the board of director's Audit Committee, the managing director (CEO), as well as various members of senior management
- Discussions among management and the staff of the IAD
- Discussions with the external auditor(s)
- Consideration of applicable laws and regulations
- Analyses of Financial and operational data
- Review of previous audit findings and recommendations
- Industry or economical trends

A global risk assessment process should lead the Director of IAD to establish priorities for the internal audit work schedule. The Director may adjust the planned internal audit work schedule after considering other information or factors, such as coordination with external auditor(s), requests by management, or the board of directors.

At a minimum, the global risk assessment process should be performed on an annual basis. However, because conditions change, audit priorities determined through the risk assessment process may be reviewed and updated throughout the year.

A periodic risk assessment, whether performed quarterly, bi-annually, or annually, should be made to assess the effects of any major changes to the catalog of auditable activities or related risk factors that have occurred since the internal audit work schedule was prepared. This risk assessment will assist the director, in making appropriate adjustments to internal audit priorities and the internal audit work schedule.

Staffing plans and financial budgets, including the number of auditor(s) and the knowledge skills and disciplines required to perform their works, should be determined from the internal audit work schedules, administrative activities, education and training requirements, and audit research and development efforts.

The director of IAD should discuss the IAD's activities with senior management on a monthly basis. On a Quarterly basis, the director of IAD should prepare a written activity report for the board of director's Audit Committee. These discussions and reports should compare the IAD performance with its goals and internal audit work; and, expenditures with financial budgets. The director of IAD should explain the reason for major variances and indicate any action taken or needed.

3.3 Internal Audit Work Paper Standards

Internal auditing work papers should adequately document internal audit work performed by the auditor. Management of the IAD should review these work papers to ensure the objectives of the internal audit work are achieved. Audit work papers should accurately record the information obtained and the analyses performed, and should support the bases for any findings and recommendations to be reported to management.

Internal audit work papers generally serve to

- Provide the principal support for the internal audit department report
- Aid in the planning and performance of the audit work
- Document whether the audit objectives were achieved
- Facilitate third party reviews (e.g. external auditors and CMA investigators)
- Provide a basis for evaluating the IAD's quality assurance program
- Provide support, in circumstances such as, insurance claims, fraud cases, and lawsuits
- Aid in the professional development of the internal audit staff
- Demonstrate the IAD's compliance with the Institute of Internal Auditors' (IIA) - Standards for the Professional Practice of Internal Auditing

The organization, design, and content of the internal audit work papers will depend on the nature of the audit. Internal audit work papers should document the following aspects of the audit process:

- The planning process, which includes, but is not limited to: discussions with management, an overall review of the activities under review, an analyses of the internal control environment, performance of a risk assessment, identification of the system of internal controls, and the development of an internal audit work program
- The examination and evaluation of the adequacy, efficiency and effectiveness of the system of internal control
- The detailed audit procedures performed, the information obtained, the analyses made and the conclusions reached
- The review by IAD management
- The reporting of findings and recommendations to management and the board of director's Audit Committee
- Any follow-up that the management of the IAD deems necessary

Internal audit work papers should be complete and include support for audit conclusions reached. Internal audit work papers may include, but are not limited to:

- Notes and memorandums resulting from interviews
- Organizational data, such as organizational charts and job descriptions
- Copies of important contracts and agreements
- Information about operating and financial policies
- Planning documents and internal audit work programs
- Internal control questionnaires (ICQs), flowcharts, checklists, and narratives
- Results of internal control evaluations and assessments
- Letters of confirmations and representation
- Analyses and tests of transactions, processes, and account balances
- Results of analytical audit procedures
- The internal audit report and management's responses
- Audit correspondence if it documents audit conclusions reached

Internal audit work papers may be in the form of paper, tape, disks, diskettes, film, or other media. If audit work papers are in the form of media other than paper, backup copies should be maintained.

If internal auditor(s) are reporting on financial information, the audit work papers should document whether the accounting records agree or reconcile with such financial information.

Internal audit work papers should be categorized as either *Permanent* or *Current* working papers. Permanent internal audit work papers refer to any documentation, which would be useful to an auditor in a future examination or review. Current internal audit work papers, refer to documentation for the latest or most current audit file and should only pertain to the internal audit work being performed at a particular point in time.

Standardized internal audit work papers, such as internal audit work programs, internal control questionnaires (ICQs), preformatted schedules, and checklists may improve the efficiency of the internal audit work and assist in facilitating the delegation of internal audit work.

Each internal audit work paper should include a listing of the following items:

- Each audit work paper should contain a heading
- The heading usually consists of the:
 - name of the organization and the activity being audited
 - a title or description of the contents or purpose of the work paper
 - date or period covered by the audit
- Each individual audit work paper should reference the internal auditor(s) who created or obtained the documentation by his/her initial. In addition, the internal audit work paper should document the date the work paper was prepared.

- Each audit work paper should contain an index or reference number relating and cross referencing the work performed back to the internal audit work program.
- Internal audit verification symbols (tick marks) should be adequately explained.
- Sources of data should be clearly identified.

The IAD management should review all internal audit work papers to ensure that they properly support the internal audit findings and recommendations; and that all-necessary audit procedures have been performed. Management of the IAD provides evidence that the internal audit work papers have been reviewed by initialing and dating the individual internal audit work papers, The director of IAD has overall responsibility for review but may designate appropriately experienced members of the IAD to perform this review.

Evidence of supervisory review should consist of the reviewer(s) initialing and dating each work paper after his/her review.

Other review techniques that provide evidence of supervisory review include completing an Internal Audit Work Paper Review Sheet and/or preparing a memorandum specifying the nature, extent, and results of the review. Reviewers may make written record (review notes or documentation by the use of an Audit Work Paper Review Checklist) of questions arising from the review process. When clearing review notes, the management of the IAD should be careful to ensure that the work papers provide adequate evidence that questions raised during the review have been resolved. Acceptable alternatives with respect to disposition of review notes is as follows:

- Retain the review notes as a record of the questions raised by the reviewer and take appropriate steps toward their resolution.
- Discard the review notes after the work papers have been amended to provide additional information requested.

Internal audit work papers are the property of the organization and should generally remain under the control of the IAD. Internal audit work papers should be accessible only to authorized personnel (e.g. external auditors, CMA inspectors, by order of a court).

Management and other members of the organization may request access to the audit work papers. Such access may be necessary to substantiate or explain audit findings or to use audit documentation for other business purposes. These requests for access should be subject to the approval of the Director of Internal Auditing.

It is common practice for internal and external auditor(s) to grant access to each other's audit work papers. Access to audit work papers by external auditor(s) should be subject to the approval of the director of IAD.

There are circumstances where requests for access the IAD's work papers and reports are made by outside parties other than the external auditor(s). Before releasing such documents, the director of IAD should obtain approval of senior management and/or legal counsel, as appropriate.

The director of IAD should develop an adequate file retention schedule for all the IAD's work. This retention schedule should be consistent with the organization's guidelines and any pertinent legal or other requirement. At a minimum, the IAD should maintain its files within the IAD for a period of 3 years (Current year and the previous 2 years). After that, files should be sent to an off-site storage facility for a period of 4 years. Files and documents older than 7 years then can be destroyed.

3.4 Internal Audit Reporting Standards

3.4.1.

At the conclusion of an examination, review, investigation, or audit, the internal auditor(s) should report to management the results of their work. A signed, written report should be issued to all pertinent parties after the work is completed. When the internal auditor's work is performed over a lengthy period, the auditor should consider issuing interim audit report(s). Interim audit reports may be written or oral and could be transmitted formally or informally.

- a) Interim reports may be used to communicate information which requires immediate attention, to communicate a change in the audit scope, or to keep management informed of the audit's progress when audits extend over a long period of time. The use of interim reports does not diminish or eliminate the need for a final report.
- b) Summary reports highlighting audit results may be appropriate for levels of management above the auditee.
- c) The term *signed* means that "the authorized internal auditor(s)'s name should be manually signed in the report." Alternatively, the signature may appear on a cover letter. The director of IAD should designate the individual auditor authorized to sign the report.
- d) If audit reports are distributed by electronic means, a signed version of the audit report should be kept on file in the internal audit department.

3.4.2

Internal auditor(s) should discuss conclusions and recommendations at appropriate levels of management before issuing a final written report.

- a) Discussion of conclusions and recommendations are usually accomplished during the course of the audit and/or at post-audit meetings (exit interviews). Another technique is the review of the draft audit reports by management of the auditee. These discussions and reviews help ensure that there have been no misunderstandings or misinterpretations of fact by providing the

opportunity for the auditee to clarify specific items and to express views of the findings, conclusions, and recommendations.

- b) Although the level of participants in the discussions and reviews may vary by auditee and by nature of the report, they will generally include those individuals who are knowledgeable of detailed operations and those who can authorize the implementation of corrective action.

3.4.3

Reports should be objective, clear, concise, constructive, and timely.

- a) *Objective reports* are factual, unbiased, and free from distortion. Findings, conclusions, and recommendations should be included without prejudice.
 - 1. If it is determined that a final audit report contains an error, the director of IAD should consider the need to issue an amended report that identifies the information being corrected. The amended audit report should be distributed to all individuals who received the audit report being corrected.
 - 2. An error is defined as an unintentional misstatement or omission of significant information in a final audit report.
- b) *Clear reports* are easily understood and logical. Clarity can be improved by avoiding unnecessary technical language and providing sufficient supportive information.
- c) *Concise reports* are to the point and avoid unnecessary detail. They express thoughts completely in the fewest possible words.
- d) *Constructive reports* are those which, as a result of their content and tone, help the auditee, and MCSA and lead to improvements where needed.
- e) *Timely reports* are those which are issued without undue delay and enable prompt effective action.

3.4.4

Reports should present the purpose, scope, and results of the audit; and, where appropriate, audit reports should contain an expression of the auditor's opinion.

- a) Although the format and content of the audit report may vary by organization or type of audit, they should contain, at a minimum, the purpose, scope, and results of the audit.
- b) Audit reports may include background information and summaries. Background information may identify the organizational units and activities reviewed, and provide relevant explanatory information. They may also include the status of findings, conclusions, and recommendations from prior reports. There may also be an indication of whether the report covers a

scheduled audit or the response to a request. Summaries, if included, should be balanced representations of the audit report content.

- c) The purpose statement should describe the audit objectives and may, where necessary, inform the reader why the audit was conducted and what it was expected to achieve.
- d) Scope statements should identify the audited activities and include, where appropriate, supportive information such as time period audited. Related activities not audited should be identified, if necessary, to delineate the boundaries of the audit. The nature and extent of auditing performed also should be described.
- e) Results may include findings, conclusions (opinions), and recommendations.
- f) Findings are pertinent statements of fact. Those findings, which are necessary to support or prevent misunderstanding of the internal auditor(s)'s conclusions and recommendations, should be included in the final report. Less significant information or findings may be communicated orally or through informal correspondence.
- g) Audit findings emerge by a process of comparing what should be with what is. Whether or not there is a difference, the internal auditor(s) has a foundation on which to build the report. When conditions meet the criteria, acknowledgement in the audit report of satisfactory performance may be appropriate. Internal audit *findings* should be based on the following attributes:
 - 1. *Criteria*: The standards, measures, or expectations used in making and evaluation and/or verification (what should exist).
 - 2. *Condition*: The factual evidence, which the internal auditor(s) found in the course of the examination (what does exist).
 - 3. *Cause*: The reason for the difference between the expected and actual conditions. (why the difference exists).
 - 4. *Effect*: The risk or exposure the auditee and/or others encounter because the condition is not the same as the criteria (the impact of the difference). In determining the degree of risk or exposure, internal auditor(s) should consider the effect their audit findings may have on MCSD's financial statements.
 - 5. Reported findings may also include recommendations, auditee accomplishments, and supportive information if not included elsewhere.
- h) Conclusions (opinions) are the internal auditor(s)' evaluations of the effects of the findings on the activities reviewed. They usually put the findings in perspective based upon their overall implications. Audit conclusions, if included in the audit report, should be clearly identified as such. Conclusions may encompass the entire scope of an audit or specific aspects. They may

cover, but are not limited to, whether the operating or program objectives and goals of the auditee conform with the overall objectives and goals of MCSD; whether these objectives and goals are being met, and whether the activity under review is functioning as intended.

3.4.5

Internal audit reports may include recommendations for potential improvements and acknowledge satisfactory performance and corrective action.

- a) Recommendations are based on the internal auditor(s)'s findings and conclusions. They call for action to correct existing conditions or improve operations. Recommendations may suggest approaches to correcting or enhancing performance as a guide for management in achieving desired results. Recommendations may be general or specific. For example, under some circumstances, it may be desirable to recommend a general course of action and specific suggestions for implementation. In other circumstances, it may be appropriate only to suggest further investigation or study.
- b) Auditee accomplishments, in terms of improvement since the last audit or the establishment of a well-controlled operation, may be included in the internal audit report. This information may be necessary to fairly represent the existing conditions and to provide proper perspective and appropriate balance to the audit report.

3.4.6

The auditee's views about audit conclusions or recommendations may be included in the audit report.

- a) As part of the internal auditor(s)' discussions with the auditee, the internal auditor(s) should try to obtain agreement on the results of the audit and on a plan of action to improve operations, as needed. If the internal auditor(s) and auditee disagree about the audit results, the audit report may state both positions and the reasons for the disagreement. The auditee's written comments may be included as an appendix to the audit report. Alternatively, the auditee's views may be presented in a summary report to the Board of Director's Audit Committee or in the cover letter.

3.4.7

The director of IAD or his/her designee should review and approve the final audit report before issuance and should decide to whom the report will be distributed.

- a) The director of IAD or his/her designee should approve and may sign all final reports. If specific circumstances warrant, consideration should be given to having the auditor-in-charge, supervisor, or lead auditor sign the report as a representative of the director of IAD.
- b) Audit reports should be distributed to those auditees who are able to ensure that the audit results are given due consideration. This means that the report

should go to those who are in a position to take corrective action or ensure that corrective action is taken. The final audit report should be distributed to management of the auditee. Higher level members of MCSD (i.e. Chairman, Deputy Chairman and Managing Director, and General Manager) may receive only a summary report. Reports may also be distributed to other interested or affected parties such as external auditor(s) and the board of director's Audit Committee.

- c) Certain information may not be appropriate for disclosure to all report recipients because it is privileged, proprietary, or related to improper or illegal acts. Such information, however, may be disclosed in a separate report. If conditions being reported involve senior management, report distribution should be to the board of director's Audit Committee.

3.5 Internal Audit Department's File Organization Standards

Internal audit work papers, usually, are organized into two types of audit files:

3.5.1

Permanent Files should include, but are not limited to the following categories:

- Definition of area or activity under review and its functions and operating objectives and goals
- Audit objectives and internal control objectives
- Functional operating policies and procedures
- Organizational chart
- Identification of key personnel
- Identification of risks
- Flowchart of the operational process
- Any internal control documentation
- Other pertinent documentation

3.5.2

Current Work Paper Files should include, but are not limited to the following categories:

- Audit work program
- Internal control questionnaire (ICQ)
- Internal control checklists
- Documentation of work performed
- Documentation of findings and recommendations

- Audit Report – drafts
- Audit Report - final
- Management's response
- Identification of follow up to be performed
- Interim work to be scheduled

4 PERFORMANCE OF INTERNAL AUDIT WORK

4.1 Planning the Internal Audit

The internal auditor(s) should adequately plan each investigation, review, examination or audit. The planning phase should adequately document the process, and should include a performance of the following steps.

4.1.1

The IAD management should determine the necessary resources that are available to perform the investigation, review, examination, or audit. The IAD management should consider the following in determining the necessary resources available:

- a) The number and experience level of the internal audit staff required. IAD management should evaluate the nature and complexity of the audit assignment, as well as, the time it should take the internal auditor(s) to complete the investigation, review, examination, or audit.
- b) The knowledge, skills, and disciplines of the internal auditing staff in selecting specific internal auditor(s) for the audit assignment.
- c) The training needs of the internal auditor(s). Since each assignment serves as a basis for meeting developmental needs of the internal audit department.
- d) In addition, the IAD management should consider the use of external resources, in instances where additional knowledge, skills, and disciplines could be utilized.

4.1.2

The internal auditor(s) assigned to the audit should discuss the assignment with the IAD management to establish the individual audit objectives and define the scope of the assignment.

- a) Audit objectives are broad statements developed by internal auditor(s) and define intended audit accomplishments. General audit objectives are applied to each auditee so that internal auditors identify detailed audit objectives for the area or activity under review. General audit objectives are to:
 - Review reliability, integrity, and confidentiality of financial and operating information pertaining to MCSD and its participants and customers and review the means used to identify, measure, classify, and report such information.
 - Review the systems established to ensure compliance with those policies, plans, procedures, laws, and regulations, which could have a significant impact on operations and reports, and should determine whether the auditee is in compliance.

- Review the means of safeguarding assets of MCSD and funds and securities of its participants and customers and verify the existence of such assets.
- Review economy, effectiveness, and efficiency by which resources allocated to MCSD and each auditee within MCSD are employed.
- b) *Audit procedures* define the methods by which audit objectives are achieved. Auditor should select a combination of audit procedures that achieves the audit objectives in an effective and efficient manner.

Audit objectives and procedures, when reviewed together, should define the scope of the internal auditor(s)'s work. Audit objectives and procedures should address the risks associated with the area or activity under review. The purpose of performing a risk assessment during the planning phase of the audit is to identify significant areas of the auditee activity.

4.1.3

The internal auditor(s) should obtain sufficient background information about the area or activities under review, before the audit being performed.

- a) A review of background information allows the internal auditor(s) to gain an understanding of the area or activity he/she will review. The specific information the internal auditor(s) should obtain and review may include, but is not limited to:
 - The individual goals and objectives of the area or activity under review
 - Any policies and procedures, laws and regulations, contracts, or organizational plans, which could have a significant impact on area, activity, operations and reports
 - Any organizational information, which the internal auditor(s) feels, may be of assistance in gaining an understanding of the area or activity under review. (e.g., number and names of employees, key employees, job descriptions, and details about recent changes in the organization including major system changes)
 - Any financial data, budget information, or operational reports, that are readably available for the area or activity under review
 - Any previously prepared audit work papers
 - Any readably available reports from internal or external sources, within MCSD, such as previous internal audit work, internal or external analyses, reviews performed from other audits, including the work of external auditor(s), completed or in the process
 - Any relevant correspondence received by the IAD to determine potential and significant audit issues

- Any authoritative and technical material or literature deemed appropriate to the area or activity under review
- b) Any other requirements of the audit, such as the audit period covered and estimated completion date, should be determined by the IAD management. In addition, the internal auditor(s) should define the format of the final internal audit report, since proper planning at this stage facilitates writing the final report.

4.1.4

The internal auditor(s) should perform a risk assessment survey.

This survey allows the internal auditor(s) to become familiar with the activities, risks, and the overall system of internal controls. The risk assessment survey permits an informed approach to planning and carrying out audit work, and is an effective tool for applying the IAD's resources most effectively. In addition, the risk assessment survey helps the internal auditor(s) to identify any areas or activities to be emphasized in the performance of his/her assignment.

- a) The risk assessment survey is a sequential process for gathering information, without detailed verification, on the area or activity under review. The main purposes of this survey is to:
 - Allow the internal auditor(s) to understand the activities under review
 - Identify significant areas warranting special emphasis
 - Obtain information for use in performance of the audit
 - Identify any other areas or activities, that could require further auditing procedures being added to the internal audit work program
- b) The focus of the risk assessment survey will vary upon the nature of the audit and the familiarity of the internal auditor(s) knowledge of the activity under review.
- c) The scope of the work and the time requirements of the survey will vary
 - Contributing factors in determining the scope and time requirements include the internal auditor(s) training and experience; knowledge of the area of activity under review; the type of audit being performed; and whether the risk assessment survey is part of a recurring or follow-up assignment. Time requirements will also be influenced by the size and complexity of the activity being examined, and by the geographical dispersion of the activity.
- d) A risk assessment survey may involve the use of one or more the following processes, but is not limited to any one of these processes:
 - Discussions with the auditee

- Interviews with organizational personnel affected by the activity (e.g. users of the activity output)
 - On-site observations of the work flow
 - Review of management reports and studies
 - Analytical auditing procedures
 - Flowcharting of individual transactions or operational workflow
 - Functional “walk thru” (tests of specific work activities from beginning to end)
 - Narrative documentation of key internal control systems or activities
- e) The internal auditor(s), at the conclusion of the risk assessment survey should prepare a documented summary of results. The summary should identify:
- Any significant audit issues and reasons for pursuing them in more depth
 - Any pertinent information developed during the risk assessment survey
 - Any audit objectives, audit procedures, and special approaches such as computer-assisted audit techniques
 - Any potentially critical internal control points, internal control deficiencies, and or excess controls
 - Verification or modification of preliminary estimates of time and resource requirements that were originally discussed with the IAD’s management
 - Any recommendations for revised dates for reporting phases and completing the audit
 - When applicable, any specific reasons or recommendations for not performing or completing the audit at that time

4.1.5

The internal auditor(s) should draft an internal audit work program, or update the current work program for the IAD management’s review and approval. The internal audit work program should detail the internal audit procedures the internal auditors will follow, including the testing and sampling techniques employed. An adequately developed internal audit work program details the steps or process by which the internal auditor will perform his/her investigation, review, examination or audit. The outlined steps or process in the internal audit work program should directly correspond to the objectives and scope of the investigation, review, examinations or audit which is to be performed. These procedures outlined and the techniques to be used should be defined and

approved by the IAD's management; selected in advance and where practical, expanded or altered, if circumstances warrant.

- a) An adequately developed internal audit work programs should:
- Clearly and concisely, state the IAD's objectives for performing the investigation, review, examination, or audit
 - Detail and identify the scope and the degree of testing required to achieve the defined audit objectives during the performance of each phase of the audit
 - Identify and document the nature and extent of testing required throughout the audit process
 - Identify and document the procedures to verify the technical aspects, risks, processes, and transactions, to review and analyze throughout the audit process
 - Document the internal auditor('s)' procedures for collecting, analyzing, interpreting, and documenting information to be reviewed during the investigation, review, examination, or audit

4.1.6

The internal auditor(s) should determine and document how, when, and to whom the internal audit results, findings and recommendations will be reported. The Director of IAD is responsible for determining how, when, and to who audit results, findings and recommendations will be reported or communicated to. The possibilities include the auditee, management, senior management, and/or the board of director's Audit Committee. This determination should be documented and communicated to management, to the extent deemed practical, during the planning phase of the audit. Subsequent changes that affect the timing or reporting of the internal audit results should also be communicated to management, if appropriate.

4.1.7

The draft or update of the internal audit work program should be approved in writing by the director of IAD or his/her designee before the commencement of the audit fieldwork. Any subsequent necessary adjustments to the internal audit work program should be approved in a timely manner. Initially, approval may be obtained orally, if factors preclude obtaining written approval before the commencing the audit fieldwork.

4.2 Examining and Evaluating Information

The internal auditor(s) should obtain, analyze, interpret, and document adequate information to support the audit results, findings and recommendations. The process of investigation, review, examination and evaluation of information about the area or activity under review is as follows:

4.2.1

IAD management, in coordination with the internal auditor(s), should schedule and conduct a meeting with the management personnel responsible for the area or activity under review.

- a) Topics of discussion may include, but are not limited to:
- The defined audit objectives and the scope of work.
 - The period in which the audit work will be performed.
 - An introduction of the internal auditor(s) assigned to perform the investigation, review, examination, or audit
 - The process by which the internal auditor(s) will communicate throughout the audit, including the method(s), how often and individuals who will be responsible for the internal audit work papers and report.
 - The current business conditions and operations of the area or activity under review, including but not limited to recent changes in management, risks, major systems, operating policies, or procedures.
 - Any problems, concerns or requests that management may want the audit to emphasize.
 - Any matters of particular interests or concerns to the internal auditor(s)
 - A description of the IAD's reporting procedures and follow-up process
- b) The internal auditor(s) should document a summary of all matters discussed at this meeting, any necessary changes to the scheduled fieldwork, and any conclusions reached. If deemed necessary, a copy of this summary document should be distributed to any individuals deemed appropriate, with the original being retained in the current audit work paper file.

4.2.2

Using the internal audit work program, checklists, ICQs or any other work papers designed and/or developed during the planning phase, the internal auditor(s) should perform the internal audit procedures outlined. Information should be collected on all matters related to the audit objectives and the scope of the work.

- a) Internal auditors should use analytical auditing procedures when examining and evaluating financial and non-financial information.
- b) The application of analytical auditing procedures is based on the premise that, in the absence of known conditions to the contrary, relationships among information may reasonably be expected to exist and continue. Examples of the contrary conditions include unusual or nonrecurring transactions or events, accounting, organizational, operational, environmental, and

technological changes, inefficiencies, ineffectiveness, errors, irregularities, or illegal acts.

- c) Analytical auditing procedures provide internal auditors with an efficient and effective means of assessing information collected in an audit. The assessments results from comparing such information with expectations identified or developed by the internal auditor.
- d) Analytical auditing procedures are useful in identifying, among other things:
 - Differences that are not expected
 - The absence of differences when they are expected
 - Potential errors
 - Potential irregularities or illegal acts
 - Other unusual or nonrecurring transactions or events
- e) Analytical auditing procedures may include:
 - Comparison of current period information with similar information from prior periods
 - Comparison of current period information with budgets and forecasts
 - Study of relationships of financial information with the appropriate non-financial information (for example recorded shareholders list fees with number of companies registered)
 - Study the relationship among elements of information (for example membership fees with number of MCSD members at each category)
 - Comparison of information with similar information for other organizational areas within MCSD (for example numbers of issuers at the central registry with number of issuers at the central depository)
 - Comparison of internal information with external information (for example compare number and volume of securities' settlements with number and volume trades on the stock exchange)
- f) Analytical auditing procedures assist internal auditor(s) in identifying conditions that may require subsequent internal auditing procedures. Analytical auditing procedures, also, may be used to support the internal audit results or conclusions reached from applying other internal audit procedures.
- g) Internal auditor(s) should consider the following factors in determining the extent to which analytical auditing procedures should be used:
 - The significance of the area being examined
 - The adequacy of the system of internal control
 - The availability and reliability of financial and non-financial information

- The precision with which the results of analytical auditing procedures can be predicted
- The availability and comparability of information regarding the industry in which the organization operates
- The extent to which other auditing procedures provide support for the audit results

After evaluating the aforementioned factors, the internal auditor(s) should consider and use additional auditing procedures, as necessary, to achieve the audit objectives

- h) When analytical auditing procedures identify unexpected results or relationships, internal auditor(s) should examine and evaluate such results or relationships.
- The examination and evaluation of unexpected results or relationships from applying analytical auditing procedures should include inquiries of management and the application of other auditing procedures until the internal auditor(s) are satisfied that the results or relationships are sufficiently explained.
- Unexplained results or relationships from applying analytical auditing procedures may be indicative of a significant condition that may result in a potential error, irregularity, or illegal act.
- Results or relationships from applying analytical auditing procedures that are not sufficiently explained should be communicated to the appropriate levels of management. Internal auditor(s) may recommend appropriate courses of action, depending on the circumstances.

4.2.3

The internal auditor(s) should evaluate the information obtained.

Information obtained by the internal auditor(s) should be sufficient, competent, relevant, and useful. The information obtained should provide a sound basis for the development of an opinion on the adequacy and effectiveness of the systems of internal control.

- a) *Sufficient information* is factual, adequate, and convincing so that a prudent, informed person would reach the same conclusions as the auditor.
- b) *Competent information* is reliable and the best attainable with appropriate audit techniques.
- c) *Relevant information* supports audit findings and recommendations and is consistent with the objectives for the audit.
- d) *Useful information* helps the organization meet its goals.

4.2.4

Internal audit work papers should adequately document the internal audit fieldwork. The internal auditor(s) should ensure that the internal audit work papers adequately describe the fieldwork performed. These papers should record the information obtained and the analyses made and should support the basis for the findings and recommendations to be reported. IAD management should document that the internal audit work papers were reviewed and that the audit objectives were achieved. Please refer to section 2.3 (Internal Audit Work Paper Standards) for more details on standards for preparing and reviewing audit work papers.

4.3 Communicating the Results of the Internal Audit

4.3.1

If the internal audit fieldwork is extended or if the fieldwork goes beyond 30 days, the internal auditor may want to consider issuing an interim audit report describing the status of the work in process.

- a) Interim reports may be used to communicate information that requires immediate attention, to communicate a change in the audit scope, or to keep management informed of the audit's progress when audits extend over a long period of time. The use of interim reports does not diminish or eliminate the need for a final report.
- b) Interim reports may be written or presented orally, and may be transmitted formally or informally.

4.3.2

At the completion of the internal audit fieldwork, the internal auditor(s) should draft a report on the results of their investigation, review, examination, or audit. A draft of the report should be prepared within 10 business days of the completion of the internal audit fieldwork.

- a) The report should be objective, clear, concise, constructive, and timely (please refer to section 2.4.3 of this manual).
- b) Reports should present the purpose, scope, and results of the audit; and where appropriate, reports should contain an expression of the auditor's opinion (please refer to section 2.4.4 of this manual).
- c) Internal audit reports may include recommendations for potential improvements and acknowledge satisfactory performance and corrective action (please refer to sections 2.4.5 and 2.4.6 of this manual).

4.3.3

The internal auditor(s) should discuss the conclusions, findings and recommendations with the IAD management. The director of IAD should schedule a meeting with the appropriate levels of management before issuing a

final written report. The scheduled meeting with management (exit conference) should be scheduled no more than 5 business days after the draft report is received from the internal auditor (please refer to sections 2.4.2 of this manual).

4.3.4

After discussions with management, the final report should be prepared. The director of IAD or his/her designee should review, approve, and sign the final audit report before issuance (please refer to section 2.4.7 of this manual).

- a) The final internal audit report should be issued, no more than 15 business days after the exit conference with management.
- b) In the final internal audit report, the director of IAD should request a response from the auditee. The auditee should be given thirty 30 to respond to the findings and recommendations.

4.4 Follow up of Management's Responses to Audit Findings and Recommendations

4.4.1

The director of IAD is responsible for reviewing responses on the internal audit reports received from the auditees. The director assess the level of response to each finding and recommendation.

- a) Management is responsible for deciding the appropriate action to be taken in response to reported audit findings. The director of IAD is responsible for assessing such management action for the timely resolution of matters reported as audit findings. In deciding the extent of follow-up, internal auditor(s) should consider procedures of a follow-up nature performed by others within MCSD (e.g. managing director).
- b) In reviewing the auditee's response, the director of IAD should establish procedures to include the following:
 - 1. A period within which management's response to the audit finding is required
 - 2. An evaluation of management's response
 - 3. A verification of the response (if appropriate)
 - 4. Follow-ups audit (if appropriate)
 - 5. A reporting procedure that escalates unsatisfactory responses/actions to the appropriate levels of management
- c) Senior management may decide to assume the risk of not correcting the reported condition because of cost or other consideration. The board of

director's Audit Committee should be informed of senior management's decision on all significant audit findings.

- d) The nature timing and extent of follow-up should be determined the director of IAD.
- e) Factors which should be considered in determining appropriate follow-up procedures:
 - 1. The significance of the reported finding
 - 2. The degree of effort and cost needed to correct the reported condition
 - 3. The risks that may occur should the corrective action fail
 - 4. The complexity of the corrective action
 - 5. The period involved
- f) Certain reported findings may be so significant as to require immediate action by management. Internal auditor(s) should monitor these conditions until corrected because of the effect they may have on MCSD.
- g) There may also be instances where the director of IAD judges that management's oral or written response shows that actions already taken are sufficient when weighed against the relative importance of the audit finding. On such occasions, follow-up may be performed as part of the next audit.

4.4.2

The director of IAD should assign internal auditor(s) to follow-up and ascertain that appropriate actions have been taken to correct any findings and recommendations reported. The internal auditor(s) should determine that corrective action was taken and the desired result is being reached, or that senior management or the board of directors has assumed the risk of not taking corrective action on reported findings.

- a) Follow-up is defined "as a process by which the internal auditor determines the adequacy, effectiveness, and timeliness of actions taken by management on reported audit findings and recommendations. Findings and recommendations include relevant findings made by external auditor(s) and others.
- b) The director of IAD is responsible for scheduling follow-up activities as part of the developing audit work schedules.
- c) Scheduling of follow up work should be based on the risk and exposure involved, as well as the degree of difficulty and the significance of timing in implementing corrective action.
- d) Internal auditor(s) should ascertain that actions taken on audit findings remedy the underlying condition.

- e) The techniques used to effectively accomplish follow-up include, but are not limited to:
1. Addressing audit report findings to the appropriate levels of management responsible for taking corrective action
 2. Receiving and evaluating management's responses to audit findings during the audit or within a reasonable period after the report is issued. Responses are more useful if they include sufficient information for the Director of IAD to evaluate the adequacy and timeliness of corrective action.
 3. Receiving periodic updates from management in order to evaluate the status of management's efforts to correct previously reported conditions
 4. Receiving and evaluating reports from other organizational units assigned responsibility for procedures of a follow-up nature
 5. Reporting to senior management or the board of director's Audit Committee on the status of responses to audit findings

APPENDIX (1) JOB DESCRIPTION FORMS

Director of IAD

Purpose

- To administer the internal auditing function of MCSD
- To develop a comprehensive, practical internal audit plan covers all administrative, financial, operational and IT functions of MCSD
- To accomplish internal audit plans approved by the board of directors' Audit Committee in accordance with the internal audit standards and stipulated schedules
- To maintain effective working relations with executive and operating management

Authority and Responsibility

- Prepares a comprehensive, long-range internal audit plan covers all MCSD functions and activities
- Identifies those activities subject to audit coverage, evaluates their significance, and assesses the degree of risk inherent in the activity in terms of cost, liability, and quality
- Provides for flexibility in audit schedules so as to be responsive to management's special needs
- Presents audit plan and reports to the Audit Committee and the executive management
- Review proposals for laws, regulations and rules for the possible effect on the control environment of MCSD and its internal controls, and develop recommendations to the management on those proposals
- Overall review and approval of audit plans, programs, working papers and draft reports and, upon significance of audit findings, attends discussion of findings with the operational management
- Ensures adequate follow up of management's corrective actions by relevant audit supervisors
- Establishes the IAD internal structure
- Develop and maintain the IAD policies, procedures, administrative and personnel manuals
- Develop and maintain an effective quality assurance program for the IAD

- Obtains and maintains an audit staff capable of accomplishing the internal auditing function
- Assigns audit areas, staff, and budget to supervisory auditors
- Develops a system of cost and time control over audit assignments
- Establishes standards of performance and, by review, determines that performance meets the standards and the IAD code of ethics
- Provides advice to management with regard of internal control systems
- Participates in fraud investigations
- Participates (or assign relevant internal audit staff to participate) in investigations of MCSD participants upon a management request or instructions of the CMA
- Studies, investigates and reports on complaints sent to board of directors and executive management
- Coordinates audit efforts with the external auditors
- Coordinate with the executive management the performance of the internal audits
- Provides MCSD executive management and board of directors' Audit Committee with reports on findings and recommendations of the internal audits, and solicit its feedback to improve these audits in the future to meet management needs
- Establishes and monitors accomplishment of the IAD objectives and approved plans

Supervisor

Purpose

- To develop a comprehensive, practical internal audit plan covers the assigned area(s) of MCSD functions
- To supervise the activities of auditors assigned to the review of various activities in the area(s) assigned
- To ensure conformance with the internal audit standards, plans, budgets, and schedules.
- To maintain effective working relations with operating management
- To provide for and conduct research, develop manuals and training guides

Authority and Responsibility Under the General Guidance of the IAD

Director

- Assigns staff to audit tasks within area(s) assigned to the supervisor by the IAD director and develops audit schedules
- Arranges with the operational management of areas of review for the performance of the audits
- Supervises the work of auditors engaged in the reviews of organizational units and functional activities of MCSD as assigned
- Reviews and approves the purpose, scope, and audit program of each audit area
- Directs audit assignments to ensure maintenance of the professional standards in planning and execution of the audit work
- Counsels and guides auditors to see that the approved audit objectives are met and that adequate, practical coverage is achieved
- Reviews audit work papers developed by the senior auditor in charge and carries out general review of other working papers and wrap up audit files for the IAD director review
- Reviews and edits audit reports and, in arrangement with the senior auditor in charge, discusses the reports with the appropriate operational management
- Provides for and performs research on audit techniques
- Develops proposals, to the IAD director, for recruiting, selecting, training, evaluating, and supervising of staff auditors
- Participates in developing manuals and other training aids
- Accumulates data, maintains records, and prepares reports on the administration of audit assignments
- Identifies factors causing deficient conditions and recommends courses of action to improve the conditions, including special surveys and audits
- Follow up corrective action plans taken by operational management in response to the audit reports findings and recommendations
- Provides for a flow of communication from operating management to the IAD director. Assists in evaluating overall results of the audits

Senior Auditor

Purpose

- To conduct reviews of assigned organizational and functional activities

- To evaluate the adequacy and effectiveness of the management controls over those activities
- To determine whether organizational units in MCSD are performing their planning, accounting, custodial, or control activities in compliance with management instructions, approved policies and procedures, and in a manner consistent with both MCSD objectives and high standards performance
- To plan and execute audits in accordance with internal audit standards
- To draft audit reports of findings and to make recommendations for correcting unsatisfactory conditions, improve operations, and reducing cost
- To perform special reviews as assigned
- To direct the activities of assistants

Authority and Responsibility Under the General Guidance of a Supervising Auditor:

- Surveys functions and activities in assigned areas to determine the nature of operations and the adequacy of the system of control to achieve established objectives
- Determines the direction and thrust of the proposed audit effort
- Plans the scope of the audit, and prepares audit programs
- Determines the auditing procedures to be used, including statistical sampling and the use of electronic data processing software
- Identifies the key control points of the system
- Evaluates the system's effectiveness through the application of a knowledge of business systems, including financial, administrative, technical and IT operations, and an understanding of auditing techniques
- Recommends necessary staff needed to carry out the audit
- Performs the audit in a professional manner and in accordance with the approved audit program
- Obtains, analyzes, and appraises evidentiary data as a basis for an informed, objective opinion on the adequacy and effectiveness of the system and the efficiency of performance of the activities being reviewed
- Directs, counsels, and instructs all assistants assigned to the audit, and reviews their working papers for sufficiency of scope and for accuracy. Prepares audit files for review by the supervising auditor

- Makes oral or written presentations, in arrangement with the supervising auditor, to management during and at the conclusion of the examination discussing deficiencies and recommending corrective action to improve operations and reduce cost
- Draft audit reports, expressing opinions on the adequacy and effectiveness of the system and the efficiency with which activities are carried out
- Appraises the adequacy of the corrective action taken to improve deficient conditions